Module E

Exempt Facility Bonds

Overview

Introduction

Module D discussed the private activity bond tests. In that lesson, you learned that if a bond met the private business tests or the private loan financing test, then it was a private activity bond. You know from Module B that the interest on private activity bonds is not tax-exempt (under IRC § 103(b)(1)), unless the bonds are **qualified** private activity bonds.

Contents

This module contains the following topics:

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Overview, Continued

Objectives

At the end of this lesson, the student will be able to:

- Identify and define each type of exempt facility.
- Explain the requirements of ALL exempt facility bonds.
- Describe the special requirements of each type of exempt facility bond.
- Identify rules found in other sections of the Code that apply to exempt facility bonds.

What is a Qualified Private Activity Bond?

IRC § 141(e) defines a **qualified** private activity bond as any private activity bond as follows:

1. The bond must be one of the following types:
    - an exempt facility bond (IRC § 142(a)),
    - a qualified mortgage bond (IRC § 143(a)),
    - a qualified veterans' mortgage bond (IRC § 143(b)),
    - a qualified small issue bond (IRC § 144(a)),
    - a qualified student loan bond (IRC § 144(b)),
    - a qualified redevelopment bond (IRC § 144(c)), OR
    - a qualified 501(c)(3) bond (IRC § 145).
2. The bond must meet the applicable volume cap requirements of IRC § 146, AND
3. The bond must meet the applicable requirements of IRC § 147.

Preview of Modules E through I

With this in mind, Modules E through I discuss in more depth the various types of qualified private activity bonds. Each type has specific requirements that must be met under the section in which it is described.

Module E begins with a discussion of exempt facility bonds, as described in IRC § 142.

Introduction to Exempt Facility Bonds

Definition of Exempt Facility Bond

An exempt facility bond is any bond issued pursuant to IRC § 142, at least 95 percent of the net proceeds of which are used, **or to be used**, to finance the following facilities ("exempt facilities"):

- airports,
- docks and wharves,
- mass commuting facilities,
- facilities for furnishing of water,
- sewage facilities,
- solid waste disposal facilities,
- qualified residential rental facilities,
- facilities for the local furnishing of electric energy or gas,
- local district heating and cooling facilities,
- qualified hazardous waste facilities,
- high-speed intercity rail facilities,
- environmental enhancements of hydroelectric generating facilities, OR
- qualified public educational facilities.

Statutory Provisions

The specific requirements for exempt facility bonds are provided in IRC § 142.

Prior to the Tax Reform Act of 1986, the following facilities were also considered exempt facilities:

- sports facilities,
- convention and trade show facilities,
- parking facilities, AND
- pollution control facilities.

High-speed intercity rail facilities were added by the Technical and Miscellaneous Revenue Act of 1988.

IRC §§ 146-150 provide other requirements applicable to qualified private activity bonds, including exempt facility bonds.

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Regulations

Treas. Reg.§§ 1.103-8, 1.103-9, 1.141-7 and 8, 1.141-15, 1.141-16, 1.142-0 through 4, 1.142(a)(5)-1, 1.142(f)(4)-1, and 1.150-4 and 5 provide rules applicable to certain exempt facility bonds.

Use of Proceeds

At least 95 percent of the net proceeds of the bonds (bond proceeds less amounts in the reasonable required reserve or replacement fund) must be used to finance the facilities described in IRC § 142(a).

Prior to the 1986 Act, "substantially all" of the proceeds of the bonds had to be used to finance exempt facilities. **(See section 103(b)(4) of the 1954 Code.)**

Substantially All (for pre-1986 Bonds)

Treas. Reg.§ 1.103-8(a)(1) provides that substantially all of the proceeds are used to provide an exempt facility if 90 percent or more of such proceeds are so used.

To determine "substantially all," two rules apply:

- the proceeds are reduced by amounts properly allocable on a pro rata basis between providing the exempt facility and other uses of proceeds, AND

amounts used to provide an exempt facility include amounts paid which are properly chargeable to the facility's capital account.

Example 1

In Rev. Rul. 77-122, 1977-1 CB 23, the Service ruled that 11 percent of the bond proceeds were used to reimburse prior construction expenditures and were not valid costs of the facilities. Accordingly, the "substantially all" requirement was not met.

Example 2

In Rev. Rul. 80-171, 1980-2 CB 44, in determining whether "substantially all" of the proceeds of the bonds (100x) are used for qualifying costs, the Service ruled that proceeds are first reduced by costs of issuance (5x) and amounts deposited in the reserve fund (15x). Because 90 percent of 80x (100x less 5x less 15x) were used for qualifying costs, the "substantially all" requirement was met.

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Example 2 (continued)

However, see Rev. Rul. 90-51, 1990-1 CB 22, which made Rev. Rul. 80-171 obsolete with respect to exempt facility bonds issued after August 15, 1986 (subject to transitional rules contained in sections 1312-1318 of the TRA 1986), as amended by section 1013 of the Technical and Miscellaneous Revenue Act of 1988, P.L. No. 100-647, 102, Stat. 3537.

See also Rev. Rul. 79-332, 1979-2 CB 38, where the "substantially all" requirement was not met.

Public Use

To qualify as an exempt facility under IRC § 142, a facility must serve or be available on a regular basis for general public use, OR be part of a facility that is so used. See Treas. Reg.§ 1.103-8(a)(2).

Treas. Reg.§ 1.141-3(c), which applies to bonds issued after May 16, 1997, provides that use of financed property by nongovernmental persons in their trade or business is treated as general public use only if the property is intended to be available, and in fact is reasonably available, for use on the same basis by natural persons not engaged in a trade or business.

Use under an arrangement that conveys priority rights or other preferential benefits is not use on the same basis as the general public.

Although Treas. Reg.§ 1.141-3(c) does not directly apply to exempt facility bonds, such section is useful in understanding and applying the meaning of the term "general public use."

Section 1

Airport Facilities

General Rules

Definition

IRC § 142(a)(1) provides that the term "exempt facility bond" means any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide airports. Under Treas. Reg.§ 1.103-8(e)(2), airport facilities are facilities which are directly related and essential to:

- servicing aircraft or enabling aircraft to take off and land, OR
- transferring passengers or cargo to or from aircraft.

The facility must be located at, or in close proximity to, the take-off and landing area in order to perform its functions. See Treas. Reg.§ 1.103-8(e)(2)(ii)(a).

The examples provided in the regulations of airport facilities are:

- terminals, runways, hangars, loading facilities, repair shops, AND
- land-based navigation aids, such as radar installation.

Limitations apply regarding the financing and use of certain facilities. These limitations are discussed below.

Public Use

Treas. Reg.§ 1.103-8(a)(2) provides that the facilities must satisfy the public use requirement. The facility must serve or be available on a regular basis for general public use or be part of a facility that is so used.

A hangar or repair facility at a municipal airport will qualify as a facility for general public use even if it is owned by, leased, or permanently assigned to a private person, provided that such facility services the general public, such as a common passenger carrier or freight carrier.

An airport owned or operated by a nonexempt person for general public use is a facility for public use. However, a landing strip which by reason of a formal or informal agreement or by reason of geographic location, which will not be reasonably available for general public use is not a facility for public use.

Airport Facilities

Functionally Related and Subordinate Facilities

Treas. Reg.§ 1.103-8(a)(3) provides that an exempt facility includes any land, building, or other property functionally related and subordinate to such facility.

Treas. Reg.§ 1.103-8(e)(2)(ii)(b) provides that a facility (or a part thereof) is not functionally related and subordinate to an airport if the facility (or a part thereof):

- is NOT of a character and size commensurate with the character and size of the airport or adjacent to which the facility is located, OR
- is NOT located at or adjacent to that airport.

The regulations provide examples of facilities that are considered functionally related and subordinate to an airport.

Example 3

Facilities used primarily for the manufacture and modification of aircraft in the immediate vicinity of an airport do not qualify as facilities that are functionally related and subordinate to the airport. See Rev. Rul. 77-324, 1977-2 CB 37.

Example 4

A 270-room hotel located within ¼ of a mile of an airport's main terminal, which will have less than 10 percent of its square footage used as meeting space qualified as functionally related and subordinate to the airport. The airport had a restaurant, pub/lounge, a lobby lounge, and a spa and whirlpool. See PLR 8634008 and note that this ruling letter was issued before August 15, 1986.

Changes After the 1986 Act

IRC § 142(c)(2) provides that the term "airport" does not include any of the following facilities if used for any private business use:

- hotels (or other lodging facilities),
- retail facilities (including food and beverage facilities) located in a terminal, if the facilities are in excess of a size necessary to serve passengers and employees at the airport,
- retail facilities for passengers or the general public (including, but not limited to rental car lots) located outside the terminal,
- office buildings for individuals who are not employees of a governmental unit or of the public airport operating authority, OR
- industrial parks or manufacturing facilities.

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Mixed Use Airport Facilities

In determining the portion of costs of mixed-use airport facilities financed with tax-exempt bonds, the cost of the portions that do NOT qualify as "airport facilities" include only:

1. The structural components required for the nonqualifying portion, such as:
   - interior walls,
   - partitions,
   - ceilings, AND
   - special enclosures; AND
2. The interior furnishings of the nonqualifying facilities, such as:
   - additional plumbing,
   - electrical, AND
   - decorating costs.

The cost of the general components of the terminal or other airport facility, such as land, structural supports, and exterior walls, is NOT required to be allocated to nonqualifying portions. However, to be excluded from the nonqualifying portions, these general components must be required for the qualifying portion of the airport facilities. See H.R. Rep. No. 99-426, 99th Cong., 1st Sess., December 7, 1985, page 528.

Governmental Ownership

IRC § 142(b)(1)(A) provides that to qualify as an exempt facility, the airport facility financed with proceeds of bonds must be owned by a governmental unit.

Safe Harbor

IRC § 142(b)(1)(B) provides a safe harbor for determining governmental ownership in cases of leases or management contracts if:

- the lessee makes an irrevocable election not to claim depreciation or an investment credit with respect to the property,
- the lease term is not more than 80 percent of the reasonably expected economic life of the property, AND
- the lessee has no option to purchase the property other than at fair market value.

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Airport Facilities, Continued

Limitation on Office Space

An office is not included in the definition of "airports" under IRC § 142(a) unless:

- it is located on the premises of the airport, and
- not more than a de minimis amount of the functions performed at the office are unrelated to the day-to day operations of the airport.

Storage or Training Facilities

Under IRC § 142(c)(1), storage or training facilities directly related to an airport are treated as "airport facilities."

Other Requirements

The private activity bond rules stated in IRC §§ 147(a) through (g) and 150(b)(4) are applicable to bonds issued to finance airports under IRC § 142(a)(1). The rules of IRC § 148 and 149 also apply to bonds issued to finance airports.

IRC § 146(g)(3) provides that no volume cap allocation is required for bonds issued to finance airports.

These rules are discussed in other modules of this text.

Section 2

Docks and Wharves

General Rules

Definition

Exempt facility bonds may be issued to finance docks and wharves and their related storage or training facilities. IRC § 142(a)(2) provides that the term "exempt facility bond" means any bond issued as part of an issue 95 percent of the net proceeds of which are to be used to provide docks and wharves.

Public Use

Treas. Reg.§ 1.103-8(a)(2) provides that the facilities must satisfy the public use requirement. The facility must serve or be available on a regular basis for general public use.

A private dock or wharf owned by or leased to, and serving only a single manufacturing plant would not qualify as a facility for general public use. However, if the private owner or lessee of such dock or wharf serves the general public, such as a common passenger or freight carrier, the facility will be considered to be in general public use.

Example 5

Facilities to store and handle shipping oil owned by a corporation qualified as dock and wharves in Rev. Rul. 79-385, 1979-2 CB 40. The facilities were part of a larger system for interstate transportation of oil. The corporation was subject to Interstate Commerce Commission regulations and was required to accept offers from any oil producer for transportation through the dock and wharf facilities. Because the facility was available to other oil producers, the ruling held that the public use requirement had been met

See also Rev. Rul. 78-247, 1978-1 CB 29.

Docks and Wharves

Functionally Related and Subordinate Facilities

Treas. Reg.§ 1.103-8(a)(3) provides that an exempt facility includes any land, building, or other property functionally related and subordinate to such facility. To be considered functionally related and subordinate, the facility should be of a character and size commensurate with the character and size of the dock or wharf OR located at or adjacent to it.

Treas. Reg.§ 1.103-8(e)(2)(d)(iii) provides examples of functionally related and subordinate facilities, such as:

- the equipment needed to receive and to discharge cargo and passengers from the vessel,
- cranes and conveyors, AND

related storage, handling, office, and passenger areas.

Example 6

In Rev. Rul. 77-233, 1977-2 CB 30, the Service held that a dry dock located in a public port and used for repair and maintenance qualified as an exempt facility. The dry dock was of adequate size to repair all ships using the port and was open to the general public.

After the 1986 Act, functionally related and subordinate facilities specifically do NOT include facilities that are used in private business use. See H.R. Rep. No. 99-426, 99th Cong., 1st Sess., December 7, 1985, page 529, and the prior section of this text regarding airports.

Limitation on Office Space

Under IRC § 142(b)(2), an office is not included in the definition of a "dock" or "wharf" under IRC § 142(a) unless:

- it is located on the premises of the facility, and
- not more than a de minimis amount of the functions performed at the office are unrelated to the day-to day operations of the facility.

Storage or Training Facilities

Under IRC § 142(c)(1), storage or training facilities directly related to a dock or wharf are treated as a part of such facility.

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Other Requirements

The governmental ownership requirement of IRC § 142(b)(1) is applicable. The same safe harbors regarding leases and management contracts apply to docks and wharves as to airports.

Treatment of mixed-use facilities is the same as that for airports. See H.R. Rep. No. 426, 99th Cong., 1st Sess., December 7, 1985, page 529.

The private activity bond rules stated in IRC §§ 147(a) through (g) and 150(b)(4) are applicable to bonds issued to finance docks and wharves under IRC § 142(a)(2). The arbitrage and rebate rules of IRC § 148 and the rules of IRC § 149 also apply to these bonds.

IRC § 146(g)(3) provides that NO volume cap allocation is required for bonds issued to finance docks and wharves.

These rules are discussed in other modules of this text.

Section 3

Mass Commuting Facilities

General Rules

Definition

IRC § 142(a)(3) provides that the term "exempt facility bond" means any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide mass commuting facilities.

Treas. Reg.§ 1.103-8(e)(2)(d)(iv) states that mass commuting facilities include real property together with improvements, and personal property used in the facility, such as machinery, equipment, and furniture, serving the general public commuting on a day-to-day basis.

Mass commuting facilities do not include mass commuting vehicles. See Rev. Rul. 88-51, 1982-1 CB 74.

Public Use

Treas. Reg.§ 1.103-8(a)(2) provides that the facilities must satisfy the public use requirement. The facility must serve or be available on a regular basis for general public use. .

Mass Commuting Facilities

Functionally Related and Subordinate Facilities

Treas. Reg.§ 1.103-8(a)(3) provides that an exempt facility includes any land, building, or other property functionally related and subordinate to such facility. To be considered functionally related and subordinate, the facility should be of a character and size commensurate with the character and size of the mass commuting facility OR located at or adjacent to it.

After the 1986 Act, functionally related and subordinate facilities specifically do NOT include facilities that are used in private business use. See H.R. Rep. No. 99-426, 99th Cong., 1st Sess., December 7, 1985, page 529.

Limitation on Office Space

Under IRC § 142(b)(2), an office is not included in the definition of a "mass commuting facility" under IRC § 142(a) unless:

- it is located on the premises of the facility, and
- not more than a de minimis amount of the functions performed at the office are unrelated to the day-to day operations of the facility.

Storage or Training Facilities

Under IRC § 142(c)(1), storage or training facilities directly related to a mass commuting facility are treated as a part of such facility.

Other Requirements

The governmental ownership requirement of IRC § 142(b)(1) is also applicable. The same safe harbors regarding leases and management contracts that apply to airports apply to mass commuting facilities.

Treatment of mixed-use facilities is the same as that for airports. See H.R. Rep. 426, 99th Cong., 1st Sess., December 7, 1985, page 530.

Private activity bond rules stated in IRC §§ 146, 147(a) through (g), and 150(b)(4) are applicable to bonds issued to finance mass commuting facilities under IRC § 142(a)(3). The arbitrage and rebate rules of IRC § 148 and the rules of IRC § 149 also apply to these bonds.

These rules are discussed in other modules of this text.

Section 4

High-Speed Intercity Rail Facilities

General Rules

Definition

IRC § 142(a)(11) provides that the term "exempt facility bond" means any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide high-speed intercity rail facilities.

IRC § 142(i)(1) defines "high-speed intercity rail facilities" as any facility (not including rolling stock) for fixed guideway rail transportation of passengers and their baggage between metropolitan statistical areas using vehicles that are reasonably expected to operate at speeds in excess of 150 miles per hour between scheduled stops.

The facilities must be available for use by the general public as passengers.

Governmental Ownership

IRC § 142(i)(2) states that for high-speed intercity rail facilities to qualify as exempt facilities, they must either:

- be owned by a governmental unit, OR
- the nongovernmental owner of the facility must irrevocably elect NOT to claim any depreciation deduction or investment tax credit with respect to the bond-financed property.

Public Use

Treas. Reg.§ 1.103-8(a)(2) provides that the facilities must satisfy the public use requirement. The facility must serve or be available on a regular basis for general public use.

Use of Proceeds

IRC § 142(i)(3) provides that for the bonds to qualify as tax-exempt bonds, any proceeds of the bonds NOT used within a three-year period from the date of issuance of the bonds must be used to redeem the bonds. The redemption must occur within six months after the end of this three-year period.

High-Speed Intercity Rail Facilities

Functionally Related and Subordinate Facilities

Treas. Reg.§ 1.103-8(a)(3) provides that an exempt facility includes any land, building, or other property functionally related and subordinate to such facility. To be considered functionally related and subordinate, the facility should be of a character and size commensurate with the character and size of the mass commuting facility OR located at or adjacent to it.

After the 1986 Act, functionally related and subordinate facilities specifically do NOT include facilities that are used in private business use. See H.R. Rep. No. 99-426, 99th Cong., 1st Sess., December 7, 1985, page 529.

Limitation on Office Space

Under IRC § 142(b)(2), an office is not included in the definition of a "high-speed intercity rail facility" under IRC § 142(a) unless:

- it is located on the premises of the facility, and
- not more than a de minimis amount of the functions performed at the office are unrelated to the day-to day operations of the facility.

Storage or Training Facilities

Under IRC § 142(c)(1), storage or training facilities directly related to a high-speed intercity rail facility are treated as a part of such facility.

Other Requirements

The private activity bond rules stated in IRC §§ 147(a) through (g) and 150(b)(4) are applicable to bonds issued to finance high-speed intercity rail facilities under IRC § 142(a)(11). The rules of IRC §§ 148 and 149 also apply to these bonds. These rules are discussed in other modules of this text.

Regarding the volume cap, IRC § 146(g)(4) provides that no private activity bond allocation is required for 75 percent of the issue, but allocation is required for the remaining 25 percent, if the property is NOT owned by a governmental unit. If the bond-financed property is entirely owned by a governmental unit, then no private activity bond allocation is required.

Section 5

Qualified Residential Rental Projects

Introduction

Definition

IRC § 142(a)(7) provides that the term "exempt facility bond" means any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide qualified residential rental projects.

The term "qualified residential rental project" means a project for residential rental property that, at all times during the qualified project period, meets the set aside requirements of IRC §§ 142(d)(1)(A) or (B).

Contents

This section contains the following topics:

Residential Rental Property

What is a Residential Rental Project?

Treas. Reg.§ 1.103-8(b)(4)(i) generally provides that a residential rental project is a building or structure, which together with any functionally related and subordinate facilities, contains one or more similarly constructed units that are:

- used for other than a transient basis, AND
- available to the general public.

The regulations state that hotels, motels, dormitories, fraternity and sorority houses, rooming houses, hospital, nursing homes, sanitariums, rest homes, and trailer parks and courts are considered to be used on a transient basis and are NOT residential rental property.

Rev. Rul. 98-47, 1998-39 I.R.B. 4, (**Exhibit E-1**) describes residential rental property for purposes of IRC §§ 142(d) and 145(d). The ruling discusses three types of living accommodations in an assisted care facility.

- apartments with only the basic services of the facility including laundry, housekeeping, daily meals in common dining area, 24-hour emergency call service, planned social activities, and scheduled transportation;
- apartments with the basic services plus certain assisted-living support services; and
- apartments with the basic and support services plus continual or frequent nursing, medical or psychological services.

The ruling applies the standards in Treas. Reg.§ 1.42-11(c) in stating that if a facility makes available continual or frequent nursing, medical, or psychiatric services; the facility will not be residential rental property under IRC §§ 142(d) or 145(d). The ruling holds that the first two types of apartments are residential rental housing, while the third type is not.

See also PLR 200038001.

Building or Structure

A building or structure is a discrete edifice or other man-made construction consisting of an independent foundation, outer walls, and a roof. See Treas. Reg.§ 1.103-8(b)(8)(iv).

Single townhouses are not buildings if the foundation and outer walls and roofs are not independent. Detached townhouses and row houses would be considered buildings.

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Definition of Unit

Under Treas. Reg.§ 1.103-8(b)(8)(i), the term "unit" means any accommodation containing separate and complete facilities for living, sleeping, eating, cooking, and sanitation. The accommodations may be served by a centrally located heating and air-conditioning equipment.

For example, an apartment containing a living area, a sleeping area, bathing and sanitation facilities, and cooking facilities equipped with a cooking range, refrigerator, and sink, all of which are separate and distinct from other apartments, would constitute a unit.

In PLR 8221149, the Service ruled that the project was not a residential rental project because the kitchenettes in each unit were not intended for regular day-to-day cooking. The units were located in a retirement center and meals and other services were provided by the center to the residents and charges were imposed for such meals and services.

But see Rev. Rul. 98-47 which held that apartments are residential rental housing even though the residents were entitled to eat in a common dining facility in exchange for rent.

In PLR 8308051, the Service concluded that the facility was not a residential rental project. Although each unit had a small sink and stove, the residents had to use toilets in a common area.

In PLR 9711021, most of the units in the facility, which included a common dining area, had a sink, a cooking range, and a full-size refrigerator. However, some of the units occupied by tenants with physical or mental disabilities contained a small refrigerator and a microwave oven instead of a cooking range. The Service concluded that, under the facts and circumstances, the cooking areas of the units were complete considering the needs and characteristics of the intended occupants.

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Owner-Occupied Residences

Under Treas. Reg.§ 1.103-8(b)(4)(iv), a residential rental project does not include any building or structure that contains fewer than five units, one of which is occupied by an owner of the units.

A cooperative housing project is not a qualified residential project where half of the units are owned by the shareholders of the cooperative and the other half are rented. See Example 3 of Treas. Reg.§ 1.103-8(b)(9).

Public Use

The facility must satisfy the public use requirement under Treas. Reg.§ 1.103-8(a)(2). The units must be legally and practically available to the members of the general public. Units are not available to the general public if they are provided only for members of a social organization or a particular employer's employees.

A building that is constructed adjacent to a factory, and the factory employees are given preference in selecting tenants is not available to the general public. See Example 2 in Treas. Reg.§ 1.103-8(b)(9).

Corporate Units

The leasing of units to a corporation raises two concerns. Corporate units are not considered low or moderate income units. Plus it is possible that the corporate units fail to meet the requirements of public use and are used in transient use.

If the corporation can lease the units on the same basis as the general public (first come, first served), the units may be considered to be used in general public use. Additionally, if the corporate units provide maid service, new sheets, towels, etc., arguably, the units are operated as a hotel and used in transient use.

If the agent determines that the facility leases units to corporation, the agent is advised to contact the National Office.

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Residential Rental Property, Continued

Multiple Buildings

Under Treas. Reg.§ 1.103-8(b)(4)(ii)(a), buildings and structures are part of the same project if they:

- are proximate to one another;
- have similarly constructed units;
- are owned by the same person, for purposes of federal income tax; AND
- are financed pursuant to a common plan.

Proximate Buildings

Under Treas. Reg.§ 1.103-8(b)(4)(ii)(b), buildings and structures are proximate to one another if they are located on a single tract of land. The term "tract" means any parcel or parcels of land that are contiguous except for the imposition of a road, street, stream, or similar property.

Common Plan of Finance

Under Treas. Reg.§ 1.103-8(b)(4)(ii)(c), a common plan of financing exits if, for example, all such buildings are provided by the same issue or several issues subject to a common indenture. See also the general definition of "issue" under Treas. Reg.§ 1.150-1(c)(1).

Functionally Related and Subordinate Property

Treas. Reg.§ 1.103-8(b)(4)(iii) provides that functionally related and subordinate property to residential rental projects includes facilities for use by tenants, such as:

- swimming pools,
- other recreational facilities,
- parking areas, AND
- other facilities reasonably required for the project, such as:
    - heating and cooling equipment,
    - trash disposal equipment, OR
    - units for resident managers or maintenance personnel.

Recall also the general requirement for exempt facility bonds under Treas. Reg.§ 1.103-8(a)(3).

Income Requirements

Set-asides

For a residential rental project to qualify under IRC § 142(d), it must meet one of the following tests:

- at least 20 percent of the units in the project must be occupied by individuals and families whose income is 50 percent or less of the area median gross income (the **"20-50 test"**), OR
- at least 40 percent of the units in the project must be occupied by individuals and families whose income is 60 percent or less of the area median gross income (the **"40-60 test"**).

The applicable test must be continually satisfied throughout the qualified project period (discussed later in this module).

The income requirements are also referred to as "set-aside" requirements.

Election

The owner of the project must irrevocably elect at the time of issuance of the bonds which test will be used. The election must be made in the bond documents.

Determination of Income

Individual and family income is determined in a manner consistent with determinations of lower income facilities and area median gross income under Section 8 of the US Housing Act of 1937. See IRC § 142(d)(2)(B).

Exhibit E-2 shows a sample of HUD income determinations.

Adjustment for Family Size

Area median incomes are also adjusted for family size in accordance with Section 8 of the Housing Act. See IRC § 142(d)(2)(B).

At page 1172, the Blue Book provides that, if a project qualifies under the 20-50 test, adjustments for family size are made to determine if families are low or moderate income. As shown in the table below, a family of four generally is treated as having low or moderate income if the family has an income of 50 percent or less of the area median gross income.

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Adjustment for Family Size (continued)

Family size	Family income as a percent of area median gross income
1	35 percent or less
2	40 percent or less
3	45 percent or less
4	50 percent or less

Similar 10 percent reductions are made to family income if the 40-60 set-asides are used.

Annual Income Determinations

IRC § 142(d)(3) provides that the determination that the income of a resident meets the income tests elected by the owner must be made at least annually on the basis of the current income of the residents.

If the resident's income increases or the family size decreases, the project may no longer meet the set-aside requirements.

Maintenance of Income Requirements After Increase in Resident's Income

IRC § 142(d)(3)(B) provides that if at the time the resident first occupied the unit the project met the set-aside requirements, then the resident is deemed to meet the low or moderate income requirement.

However, once a resident's income exceeds 140 percent of the applicable income limit, no residential unit of comparable or smaller size in the project may be occupied by a new resident whose income exceeds the applicable income limit. The next available comparably sized or smaller unit must therefore be rented to a resident meeting the set-aside income requirements.

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Deep Rent Skewed Project

IRC § 142(d)(4) provides that the owner of a project may elect to satisfy an alternate set-aside requirement:

- at least 15 percent of the low-income units in the project must be occupied by tenants whose income is 40 percent or less of the area median income;
- the gross rent of each low-income unit in the project does not exceed 30 percent of the applicable income limit which applies to individuals occupying the unit; AND
- the gross rent of each low-income unit in the project does not exceed 50 percent of the average gross rent of units of comparable size which are not occupied by individuals who meet the applicable income limit.

If the income of a qualifying resident exceeds 170 percent of the applicable limit, the next available comparable size unit must be occupied by a new resident whose income does not exceed 40 percent of the area median gross income.

Gross Rent

For purposes of a deep rent skewed project, gross rent means any payment under section 8 of the Housing Act and any utility allowance that are paid from the resident's rent. See IRC § 142(d)(4)(C)(ii).

Annual Certification

IRC § 142(d)(7) requires the owner of the project to certify annually that the income requirements for the project are satisfied. The owner makes this certification by filing **Form 8703**, **Annual Certification by Operator of a Residential Rental Project.** The failure on the part of the owner to certify will not cause the bonds to become taxable. However, the owner will be subject to a penalty of $100 for each failure to certify under IRC § 6652(j).

Form 8703 is due by March 31 after the close of the calendar year for which the certification is made. See **Exhibit E-3** for Form 8703.

Continued on next page

Students as Low Income

Under Treas. Reg.§ 1.103-8(b)(8)(v) the occupants of a unit are not considered to be a low or moderate income occupants if all the occupants are students (as defined in IRC § 151(c)(4), no one of whom is entitled to file a joint return under IRC § 6013.

Therefore, an agent must review the income certifications to determine whether or not all of the occupants of a unit will be considered students within the meaning of IRC § 151(c)(4).

Two full-time students may qualify for low or moderate income occupants of a unit if they are married to each other and are filing a joint tax return.

Qualified Project Period

Definition

IRC § 142(d)(2)(A) defines the term "qualified project period." The table below illustrates this definition:

Beginning Date	Ending Date
First day that 10 percent of residential units are occupied	The latest of: • 15 years after the date that 50 percent of the units are occupied; • the first day that no tax-exempt private activity bond issued for the project is outstanding; OR • the date that any assistance for the project under section 8 of the US Housing Act of 1937 terminates.

Effect of Noncompliance

Treas. Reg.§ 1.103-8(b)(6) provides that, unless corrected within a reasonable period, noncompliance with the set-aside requirements during the qualified project period will cause the bonds to become taxable from the date of issue.

If the issuer corrects noncompliance within a reasonable period (60 days after the error is discovered or would have been discovered by the exercise of due diligence), such noncompliance will not cause the bonds to become taxable.

If the issuer fails to correct noncompliance within a reasonable time, but makes a correction after such time, the project will still be deemed to be in noncompliance, and the bonds will be taxable from the date of issuance.

Example 7

County Z issues bonds in 1987 and loans the proceeds to Corporation X to construct a residential rental project. On the date of issuance of the bonds County Z elects that at least 20 percent of the units at the project will be occupied by persons having income of 50 percent or less of the area median income. On January 1, 1991, Corporation X and County Z discover that less than 20 percent of the units are occupied by residents meeting the applicable income criteria. This noncompliance is corrected on March 15, 1991. Because the correction occurred after 60 days beyond the date of discovery, the bonds will be taxable from the date of issuance.

Continued on next page

Qualified Project Period, Continued

Example 8 On January 15, 1987, State Z issues bonds with a term of 15 years to acquire and renovate a residential rental project to be owned by Corporation X. On June 1, 1988, the first resident occupies a unit at the project. On July 1, 1988, at least 50 percent of the units are occupied. On January 15, 1991, State Z issues refunding bonds to refund the bonds. The refunding bonds have a stated maturity date of January 15, 2003. The prior bonds are retired on March 15, 1991. To qualify as a qualified residential rental project under section 142(d), the project must meet the income requirements until July 1, 2003.

Other Requirements

Limitation on Office Space

Under IRC § 142(b)(2), an office is not included in the definition of a "qualified residential rental project" under IRC § 142(a) unless:

- it is located on the premises of the project, and
- not more than a de minimis amount of the functions performed at the office are unrelated to the day-to day operations of the facility.

Private Activity Bond Rules

The following private activity bond rules are applicable to bonds issued to finance residential rental projects under IRC § 142(d):

- IRC § 146 requires that before issuance of the bonds the issuer receive volume cap allocation for the issue.
- IRC § 147(a) provides that a private activity bond will NOT be a qualified bond for any period during which it is held by a person who is a substantial user of the facility or a related person of the substantial user.
- IRC § 147(b)(1) places a limit on the average maturity of the bonds.
- IRC § 147(c) limits the amount of bond proceeds that may be used to acquire land.
- IRC § 147(d) prohibits the acquisition of existing property unless the first use of such property is pursuant to such acquisition.
- IRC § 147(e) prohibits the use of bonds to finance certain facilities.
- IRC § 147(f) provides the notice and public approval requirements.
- IRC § 147(g) limits the amount of bond proceeds that may be used for costs of issuance.
- IRC § 148 provides rules regarding arbitrage and rebate.
- IRC § 149 provides various rules for all private activity bonds.
- The requirements of IRC § 150(b)(2) regarding change in use apply.

These rules are discussed in other modules of this text.

Section 6

Facilities for Furnishing Water

General Rules

Definition

IRC § 142(a)(4) provides that the term "exempt facility bond" means any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide facilities for the furnishing of water. Under IRC § 142(e), a facility is a facility for the furnishing of water if:

- the water is or will be made available to members of the general public, AND
- either the facility is operated by a governmental unit or the rates for the furnishing or sale of water have been established or approved by a state or political subdivision thereof.

General public includes electric utility, industrial, agricultural, or commercial users.

Artesian wells, reservoirs, dams, related equipment and pipelines, and other facilities used to furnish water for domestic, industrial, irrigation, or other purposes, are included as "water facilities" under Treas. Reg.§ 1.103-8(h)(2).

Public Use

Treas. Reg.§ 1.103-8(a)(2) provides that the facility must satisfy the public use requirement. Under Treas. Reg.§ 1.103-8(h)(1), a water facility will satisfy the public use test if it will provide water on reasonable demand, to any member of the general public within the service area of the water system of which the facility is a part.

Use by a small number of private persons of 80 percent of the output of a water facility does not meet the public use requirement. See Rev. Rul. 76-494, 1976-2 CB 26. Thus, even if the facility serves a large number of members of the general public, if a large portion of the facility's output is used by a private person, the facility will not meet the requirements of IRC § 142(e) and Treas. Reg.§ 1.103-8(h)(1). See also Rev. Rul. 78-21, 1978-1 CB 26.

Facilities for Furnishing Water

Irrigation Facility Does Not Qualify

In PLR 9220036, the Service ruled that bonds issued to finance irrigation equipment to be leased to farmers in a water conservation district would not be qualified. The facility would not qualify as a "facility for the furnishing of water" as described in IRC § 142(a)(4) since it did not serve the general public, including residential users.

Functionally Related and Subordinate Facilities

Treas. Reg.§ 1.103-8(a)(3) provides that an exempt facility includes any land, building, or other property functionally related and subordinate to such facility. To be considered functionally related and subordinate, the property should be of a character and size commensurate with the character and size of the facility.

After the 1986 Act, functionally related and subordinate facilities specifically do NOT include facilities that are used in private business use. See H.R. Rep. No. 99-426, 99th Cong., 1st Sess., December 7, 1985, page 529.

Limitation on Office Space

Under IRC § 142(b)(2), an office is not included in the definition of a "facility for the furnishing of water" under IRC § 142(a) unless:

- it is located on the premises of the facility, and
- not more than a de minimis amount of the functions performed at the office are unrelated to the day-to day operations of the facility.

Other Requirements

The private activity bond rules stated in IRC §s 146, 147(a) through (g), and 150(b)(4) are applicable to bonds issued to finance facilities for the furnishing of water under IRC § 142(a)(4). The arbitrage and rebate rules of IRC § 148 and the rules of IRC § 149 also apply to these bonds.

These rules are discussed in other modules of this text.

Section 7

Sewage Facilities

General Rules

Definition

IRC § 142(a)(5) provides that the term "exempt facility bond" means any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide sewage facilities. The Code does not define a sewage facility, however, Treas. Reg.§ 1.142(a)(5)-1 provides guidance on the types of property that may be financed as sewage facilities and other applicable definitions.

Public Use

Treas. Reg.§ 1.103-8(a)(2) provides that the facilities must satisfy the public use requirement, however, under Treas. Reg.§ 1.103-8(f)(1)(i), sewage facilities will be treated in all events as serving the general public.

Properties Which May Be Financed

Treas. Reg.§ 1.142(a)(5)-1(b)(1) describes the properties that may qualify as sewage facilities under IRC § 142(a)(5) as those:

- used for the secondary treatment of wastewater that has a reasonably expected average daily raw wasteload concentration of biochemical oxygen demand (BOD) that does not exceed 350 milligrams per liter as oxygen (the BOD limit) (oxygen is measured upon entry into the facility);
- used for the preliminary and/or primary treatment of wastewater, to the extent used in connection with secondary treatment (pretreatment is NOT included);
- used for advanced or tertiary treatment of wastewater in connection with and after secondary treatment;
- used for the collection, storage, use, processing and final disposal of certain wastewater and sewage sludge;
- used for the treatment, collection, storage, use, processing, or final disposal of septage; AND
- functionally related and subordinate to the properties described above.

Exception for BOD Limit

If a facility treating wastewater exceeds the BOD limit, it will not fail to qualify to the extent that the failure is due to implementation of a federal, state, or local water conservation program. See Treas. Reg.§ 1.142(a)(5)-1(b)(2)(i).

Sewage Facilities

Anti-Abuse Rule

If there are any intentional manipulations of the BOD level to circumvent the BOD limit, the facility will not qualify. For example, increasing the volume of water in the wastewater before influent enters the facility with the intention of reducing the BOD limit. See Treas. Reg.§ 1.142(a)(5)-1(b)(2)(ii).

Property Not Included as Sewage Facility

If a property is not described in Treas. Reg.§ 1.142(a)(5)-1(b)(1), it is not a sewage facility under IRC § 142(a)(5). For example, a property is not a sewage facility or functionally related and subordinate property, if such property is used for pretreatment of wastewater, or related collection, storage, use, processing, or final disposal of the wastewater. In addition, property used to treat, process, or use wastewater subsequent to the wastewater's discharge into navigable water, is not a sewage facility.

Functionally Related and Subordinate Facilities

Treas. Reg.§ 1.103-8(a)(3) provides that an exempt facility includes any land, building, or other property functionally related and subordinate to such facility. To be considered functionally related and subordinate, the property should be of a character and size commensurate with the character and size of the facility.

After the 1986 Act, functionally related and subordinate facilities specifically do NOT include facilities that are used in private business use. See H.R. Rep. No. 99-426, 99th Cong., 1st Sess., December 7, 1985, page 529.

Limitation on Office Space

Under IRC § 142(b)(2), an office is not included in the definition of a "sewage facility" under IRC § 142(a) unless:

- it is located on the premises of the facility, and
- not more than a de minimis amount of the functions performed at the office are unrelated to the day-to day operations of the facility.

Other Requirements

The private activity bond rules stated in IRC §§ 146, 147(a) through (g), and 150(b)(4) are applicable to bonds issued to finance sewage facilities under IRC § 142(a)(5). The arbitrage and rebate rules of IRC § 148 and the rules of IRC § 149 also apply to these bonds.

These rules are discussed in other modules of this text.

Section 8

Solid Waste Disposal Facilities

General Rules

Definition

IRC § 142(a)(6) provides that the term "exempt facility bond" includes any bond issued as part of an issue 95 percent or more of the net proceeds of which are used to finance "solid waste disposal facilities."

While IRC § 142(a)(6) was added to the Code as part of the Tax Reform Act of 1986, the tax-exempt financing of solid waste disposal facilities was already permitted under section 103(b)(4)(E) of the Code of 1954. The Conference Report to the 1986 Act provides that "[t]he conference agreement allows exempt-facility bonds to be issued to finance solid waste disposal facilities, defined generally as under present law." Thus, the guidance already issued under section 103(b)(4)(E) is applicable to section 142(a)(6).

Treas. Reg.§ 1.103-8(f)(2)(ii)(a) provides that the term "solid waste disposal facilities" means any property or a portion thereof used for the collection, storage, treatment, utilization, processing, or final disposal of solid waste.

Treas. Reg.§ 1.103-8(f)(2)(ii)(c) provides that a facility which disposes of solid waste by reconstituting, converting, or otherwise recycling it into material which is not waste shall also qualify as a solid waste disposal facility if solid waste constitutes at least 65 percent, by weight or volume, of the total materials introduced into the recycling process.

The fact that a facility which otherwise qualifies as a solid waste disposal facility operates at a profit will not, of itself, disqualify the facility as an exempt facility.

Public Use

Treas. Reg.§ 1.103-8(a)(2) provides that the facilities must satisfy the public use requirement, however, under Treas. Reg.§ 1.103-8(f)(1)(i), solid waste disposal facilities will be treated in all events as serving the general public.

Solid Waste

Definition

Treas. Reg.§ 1.103-8(f)(2)(ii)(b) provides that the term "solid waste" shall have the same meaning as section 203(4) of the Solid Waste Disposal Act of 1965 except that material will not qualify as solid waste unless:

- on the date of issue of the obligations issued to provide the facility to dispose of such waste material,
- it is property which is useless, unused, unwanted, or discarded solid material,
- which has no market or other value at the place where it is located.

Where any person is willing to purchase such property, at any price, such material is not waste.

Where any person is willing to remove such property at his own expense but is not willing to purchase such property at any price, such material is waste.

The Conference Report to the 1986 Act provides that "[t]he conferees wish to clarify that solid waste does not include most hazardous waste (including radioactive waste)."

Section 203(4) of the Solid Waste Disposal Act provides that solid waste means:

- garbage,
- refuse, AND
- other discarded solid materials, including solid waste material resulting from:
    - commercial activities,
    - industrial,
    - commercial, AND
    - agricultural operations.

Solid waste does not include solids or dissolved material in domestic sewage or other significant pollutants in water resources, such as:

- silt,
- dissolved or suspended solids in industrial waste water effluents,
- dissolved materials in irrigation return flows, OR
- other common water pollutants.

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Example 9 A facility reconstituted solid materials resulting from a manufacturing process so that the materials could be reintroduced into a manufacturing process. The corporation had previously discarded the solid materials, which could not be reintroduced into the production process or sold. The facility qualified as a solid waste disposal facility since, at the time the bonds were issued to construct the facility, the discarded materials had no value at the place where they were discarded. See Rev. Rul. 72-190, 1972-1 CB 29.

Example 10 Discarded corrugated containers purchased from a waste collector by a manufacturer of fiber products did not qualify as solid waste. The containers had a value where they were located, and a corporation engaged in the business of manufacturing bleached paper board and other fiber products was willing to purchase the property at a stated price. See Rev. Rul. 75-184, 1975-1 CB 41.

Example 11 A facility leased to a corporation that collects solid waste and sells salvageable metal to scrap dealers and combustibles to an adjacent public utility plant for fuel qualifies as a solid waste disposal facility. The corporation does not pay any amount for any material dumped at the collection stations. At this point, the garbage is useless and unwanted material. See Rev. Rul. 76-222, 1976-1 CB 26.

Example 12 State law prohibits use of non-returnable containers. A facility used by a beverage manufacturer to package beverages in such containers is not a solid waste disposal facility because the containers are not solid waste. When the reusable container is returned, it is reintroduced into the distribution process and may be reused by the taxpayer. Even though there was no market for the returnable containers, the reusable containers do have a value to the taxpayer. See Rev. Rul. 80-197, 1980-2 CB 44.

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Example 13

A minimal amount of water content is permitted in "solid waste." In PLR 9143036, the Service ruled that although the wastewater effluent is 99.4 percent liquid, it qualifies as solid waste when dewatered. However, the cost of the dewatering is a non-qualifying cost.

Example 14

In TAM 199918001, City issued two series of temporary revenue bonds on two separate dates to finance the construction of a recycling facility for the benefit of Operator and then subsequently issued revenue refunding bonds solely to currently refund the original new money issues. Chief Counsel concluded that the relevant dates to test for value were the two issue dates of the separate new money issues since it is as of those dates that the City intended to spend bond proceeds on the construction of the facility.

Operator had historically purchased its solid material on the open market, and on the relevant issue dates, persons were willing to pay a price for the solid material at the locations where the Operator customarily acquired its material. Chief Counsel concluded that the material had value where it was located on the relevant issue dates, and thus, did not qualify as solid waste.

Transportation & Handling Costs

Treas. Reg.§ 1.103-8(f)(2)(ii)(b) provides that where a person is willing to remove solid material at his own expense but is not willing to purchase such material at any price, such material is waste. Thus, transportation costs incurred or reimbursed by an owner/operator of a solid waste disposal facility are not treated as part of any price paid for the waste material itself. Additionally, certain rulings have included "handling costs" in this exclusion of transportation costs from price. While handling costs have not been clearly defined, this extension has been applied on a facts and circumstances basis where the identified handling costs were closely related to the transportation costs incurred or reimbursed by the beneficiary of the tax-exempt financing.

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Example 15

Company acquires bark from outside suppliers by paying only an allowance for handling, loading, and hauling of the bark to the mill. The bark is otherwise useless, discarded, solid material that has no market value to the suppliers at the place it is located. This allowance includes a base rate plus a mileage rate which is slightly adjusted up or down depending on the moisture content of the bark delivered, based on random samples taken of bark deliveries. The Company represents that the moisture content adjustments are needed to discourage haulers from watering down the bark before delivery, compensate haulers who deliver dry loads which are bulkier and not as heavy as wet loads, and encourage haulers to deliver dry bark that can be used immediately at the mill without any delay for drying time. The adjustment for moisture content, comprising only 3.3 percent of the cost of the bark delivered to the mill, is an acceptable handling cost. See PLR 7941045.

Audit Tip

A bona fide arms-length agreement between an unrelated buyer and seller is generally the best evidence regarding whether material subject to the agreement has a market value. A long-term contract pursuant to which a buyer pays only for the supplier's transportation and handling costs in a manner that is consistent with existing rulings will continue to be a permitted method of structuring transactions and establishing that a material subject to the contract has no value. However, the IRS may always scrutinize a contract and its cost allocation to ascertain that no amount is being paid for the material and that any and all payments are properly allocable to transportation and handling costs.

The Waste Disposal Function & the Production of Valuable Material

A facility may have a solid waste disposal function and a function other than the disposal of solid waste, however, only expenditures for that portion of property which is a solid waste disposal facility qualify for tax-exempt financing under section 142(a)(6). See Treas. Reg.§ 1.103-8(f)(2)(ii)(a) and Temp. Treas. Reg.§ 17.1(a).

Temp. Treas. Reg.§ 17.1(a) provides that where materials or heat having utility or value are recovered, the waste disposal function includes the processing of such materials or heat which occurs in order to put them into the form in which the materials or heat are <u>in fact used or sold</u>.

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The Waste Disposal Function & the Production of Valuable Material (continued)

However, the waste disposal function does not include any further processing which converts the material or heat into other products. An example of this principle is provided in Temp. Treas. Reg.§ 17.1(c) (discussed below).

Example 16

At a processing facility, solid waste material collected by the operator is reduced to a small, uniform size and separated into combustible and noncombustible fractions. The combustible fraction is fed to a surge bin from which it is blown into boilers at an adjacent utility plant. The utility paid a stipulated amount per ton for the combustible fractions based on their BTU value. While the waste disposal function of the processing facility includes the processing of the waste material into the form that is subsequently sold, the waste disposal function does not include the equipment used to transport the fuel from the surge bin to the boilers because during this stage the material is no longer useless and unwanted. See Rev. Rul. 76-222, 1976-1 CB 26.

Functionally Related and Subordinate Property

Property that is related and subordinate to the solid waste facility qualifies if it is of a character and size commensurate with the character and size of the facility. See Treas. Reg.§ 1.103-8(a)(3).

IRC § 142(b)(2) provides that office space which is located on the premises of the facility qualifies as part of the exempt facility provided that not more than a de minimis amount of the work performed in that space is not directly related to the day-to-day operations of the facility.

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Example 17

In PLR 9002049, the Service ruled that specially designed trailers, road tractors and shuttle trucks, and the garage maintenance and truck washing facilities, and landfill tippers are functionally related and subordinate to the disposal facility because they are necessary for the collection, storage, and transportation of solid waste. In this case, the city's disposal site was near capacity and the city contracted with a private entity to transport and dispose of the garbage at its landfill.

Example 18

Odor control facilities installed by a corporation to a sanitary landfill are functionally related and subordinate property. See PLR 8526018.

Allocation of Cost

Temp. Treas. Reg.§ 17.1(b) provides that the qualifying portion of the facility is determined by allocating cost of the facility between the solid waste disposal function and any other function. The method of allocation adopted by the issuer should, with reference to all the facts and circumstances with respect to the facility, be reasonable and reflect a separation of costs for each function of the property.

Example 19

A facility processes waste dumped by a municipality by separating metals, glass, and similar materials. As separated, some of the items are commercially salable. The metals and glass are sold after they are sorted, altered, and cleaned, and the glass is pulverized. The waste disposal function includes the processing of the metal and glass, but not any further processing.

The remaining waste is burned at an incinerator. The gases generated are cleaned by the use of an electrostatic precipitator. The incinerator exhaust gases are cooled and reduced in volume by means of a heat exchange process using boilers. The precipitator is functionally related and subordinate to the waste disposal facility.

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Example 19 (continued)

The heat is used to produce steam and sold to the operator of an adjacent electric generating facility and used by the operator to power its turbine generator. The pipes used to carry the steam from the facility to the adjacent electric generating facility are not within the solid waste disposal function of the facility.

See Example in Treas. Reg.§ 17.1(c) (Temporary).

Other Requirements

The private activity bond rules stated in IRC §§ 146 (unless the property to be financed is to be owned by a governmental entity), 147(a) through (g) and IRC § 150(b)(4) are applicable to bonds issued to finance solid waste disposal facilities under IRC § 142(a)(6).

The arbitrage and rebate rules of IRC § 148 and the rules of IRC § 149 are also applicable to these bonds.

These rules are discussed in other modules of this text.

Section 9

Facilities for the Local Furnishing of Electric Energy or Gas

General Rules

Definition

IRC § 142(a)(8) provides that the term "exempt facility bond" means any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide facilities for the local furnishing of electric energy or gas.

Treas. Reg.§ 1.103-(8)(f)(2)(iii) provides that a facility for the local furnishing of electrical energy or gas is property that is:

- either property of a character subject to allowance for depreciation under IRC § 167 or land;
- used to produce, collect, generate, transmit, store, distribute, or convey electric energy or gas;
- used in a trade or business of furnishing electric energy or gas; AND
- a part of a system providing service to the general populace of one or more communities or municipalities, but in no event should it provide services to more than two contiguous counties whether or not such counties are located in one state. See also IRC § 142(f)(1).

Public Use

Treas. Reg.§ 1.103-8(f)(1)(ii) provides that the facility for the local furnishing of electric energy or gas is available for use by members of the general public if:

- the owner or operator of the facility is obligated (by a legislative enactment, local ordinance, regulation, or the equivalent) to furnish electric energy or gas to all persons who desire such services and are within its service area; AND
- it is reasonably expected that the facility will serve or be available to serve a large segment of the public in its service area.

Facilities for the Local Furnishing of Electric Energy or Gas

Electric Energy Transmitted Outside Area

Under IRC § 142(f)(2)(A), if a facility transmits electricity outside its local area pursuant to an order of the Federal Energy Regulatory Commission (FERC), it will not be disqualified if the portion of the cost of the facility financed with tax-exempt bonds is not greater than the portion of the cost of the facility allocable to the local furnishing of electric energy. See also Treas. Reg.§ 1.141-7.

Special Remedial Action

IRC § 142(f)(2)(B) provides for a remedy where a facility financed with tax-exempt bonds fails to meet the requirements of IRC § 142(f) due to a subsequent order by FERC. In such an event, the bonds will not become taxable if:

- an escrow is established to defease the bonds within a reasonable period of time after the order becomes final; AND
- bonds are redeemed no later than the first redemption date.

Termination of Future Financing

IRC § 142(f)(3) provides that no tax-exempt bond may be issued for a facility described in IRC § 142(a)(8) after August 20, 1996 unless:

- (A) the facility will be used by a person who is engaged in the local furnishing of energy on January 1, 1997, and to provide service within the area served by such person on January 1, 1997; OR
- (B) the facility will be used by a successor in interest to such person for the same use and within the same area as described in (A) above.

Election to Terminate Tax-Exempt Bond Financing

IRC § 142(f)(4) provides that, if a facility financed with tax-exempt bonds issued before August 20, 1996 ceases to qualify under IRC § 142(f) due to an expansion of the service area, the bonds will not become nonqualified if the furnisher makes an election and agrees that:

- the election is made with respect to all facilities for local furnishing of electricity and gas by such person;
- no tax-exempt bonds may be issued on or after August 20, 1996 with respect to such facilities of the furnisher;
- any expansion of the service area is not financed with tax-exempt bond proceeds described in IRC § 142(a)(8) and such expansion is not a nonqualifying use; AND
- all outstanding bonds which financed the facility are redeemed not later than six months after the later of the next redemption date or the election date.

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Election to Terminate Tax-Exempt Bond Financing (continued)

Treas. Reg.§§ 1.142(f)(4)-1 and 1.150-5 provide guidance on the manner of making such an election.

IRC § 150(b)(4) will not apply to any bonds identified in an election filed by the furnisher under section 142(f)(4).

Functionally Related and Subordinate Facilities

Treas. Reg.§ 1.103-8(a)(3) provides that an exempt facility includes any land, building, or other property functionally related and subordinate to such facility. To be considered functionally related and subordinate, the property should be of a character and size commensurate with the character and size of the facility.

After the 1986 Act, functionally related and subordinate facilities specifically do NOT include facilities that are used in private business use. See H.R. Rep. No. 99-426, 99th Cong., 1st Sess., December 7, 1985, page 529.

Limitation on Office Space

Under IRC § 142(b)(2), an office is not included in the definition of a "facility for the local furnishing of electric energy or gas" under IRC § 142(a) unless:

- it is located on the premises of the facility, and
- not more than a de minimis amount of the functions performed at the office are unrelated to the day-to day operations of the facility.

Other Requirements

The private activity bond rules stated in IRC §§ 146, 147 (a) through (g), and 150(b)(4) are applicable to bonds issued to finance facilities for the local furnishing of electric energy and gas under IRC § 142(a)(8).

The arbitrage and rebate rules of IRC § 148 and the rules of IRC § 149 are also applicable to these bonds.

These rules are discussed in other modules of this text.

Section 10

Local District Heating or Cooling Facilities

General Rules

Definition

IRC § 142(a)(9) provides that the term "exempt facility bond" means any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide local district heating and cooling facilities.

IRC § 142(g)(1) provides that the term "local district heating and cooling facility" means any property used as an integral part of a local district heating or cooling system.

Local District Heating and Cooling System

IRC § 142(g)(2) provides that a "local heating and cooling system" is any local system consisting of pipeline or network providing hot water, chilled water, or steam to two or more users for:

- residential, commercial, or industrial heating or cooling; OR
- processing steam.

The pipeline or network may be connected to a heating or cooling source.

A local system includes facilities furnishing heating and cooling to an area consisting of a city and one contiguous county.

Functionally Related and Subordinate Facilities

Treas. Reg.§ 1.103-8(a)(3) provides that an exempt facility includes any land, building, or other property functionally related and subordinate to such facility. To be considered functionally related and subordinate, the property should be of a character and size commensurate with the character and size of the facility.

After the 1986 Act, functionally related and subordinate facilities specifically do NOT include facilities that are used in private business use. See H.R. Rep. No. 99-426, 99th Cong., 1st Sess., December 7, 1985, page 529.

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Limitation on Office Space

Under IRC § 142(b)(2), an office is not included in the definition of a "facility for the local furnishing of electric energy or gas" under IRC § 142(a) unless:

- it is located on the premises of the facility, and
- not more than a de minimis amount of the functions performed at the office are unrelated to the day-to day operations of the facility.

Other Requirements

The private activity bond rules stated in IRC §§ 146, 147(a) through (g), and 150(b)(4) are applicable to bonds issued to finance local district heating or cooling facilities under IRC § 142(a)(9). The arbitrage and rebate rules of IRC § 148 and the rules of IRC § 149 also apply to these bonds.

These rules are discussed in other modules of this text.

Section 11

Qualified Hazardous Waste Facilities

General Rules

Definition

IRC § 142(a)(10) provides that the term "exempt facility bond" means any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide qualified hazardous waste facilities.

IRC § 142(h) provides that the term "qualified hazardous waste facility" means any facility for the disposal of hazardous waste by incineration or entombment but only if:

- the facility is subject to final permit requirements under subtitle C of Title II of the Solid Waste Disposal Act as in effect on October 22, 1986; AND
- financing is used only for the facilities (or a portion of the facility) which is used to dispose of hazardous waste generated by the general public, rather than, the owner or operator of the facility, and person related to the owner or operator.

Hazardous Waste

HR Rep. No. 841, 99th Cong., 1st Sess., September 18, 1986, page II-707 provides that "hazardous waste" does not include radioactive waste.

Applicable Rules

The rules similar to rules for solid waste disposal facilities apply to qualified hazardous waste facilities, including:

- limiting the hazardous waste materials to materials having no market or other value at the place where the waste is located, AND
- the allocation of bond proceeds to qualifying portions of the facility.

(**See Section 8 of this Module, entitled "Solid Waste Disposal Facilities.")**

A facility may qualify both as a solid waste disposal facility and a hazardous waste disposal facility. In this case, the waste processed at the facility consisted of at least 65 percent solid waste. **(See PLR 8924009.**)

Qualified Hazardous Waste Facilities

Functionally Related and Subordinate Facilities

Treas. Reg.§ 1.103-8(a)(3) provides that an exempt facility includes any land, building, or other property functionally related and subordinate to such facility. To be considered functionally related and subordinate, the property should be of a character and size commensurate with the character and size of the facility.

After the 1986 Act, functionally related and subordinate facilities specifically do NOT include facilities that are used in private business use. See H.R. Rep. No. 99-426, 99th Cong., 1st Sess., December 7, 1985, page 529.

Limitation on Office Space

Under IRC § 142(b)(2), an office is not included in the definition of a "qualified hazardous waste facility" under IRC § 142(a) unless:

- it is located on the premises of the facility, and
- not more than a de minimis amount of the functions performed at the office are unrelated to the day-to day operations of the facility.

Other Requirements

The private activity bond rules stated in IRC §§ 146, 147(a) through (g), and 150(b)(4) are applicable to bonds issued to finance local district heating or cooling facilities under IRC § 142(a)(9). The arbitrage and rebate rules of IRC § 148 and the rules of IRC § 149 also apply to these bonds.

These rules are discussed in other modules of this text.

Section 12

Environmental Enhancement Hydro-Electric Generating Facilities

General Rules

Definition

IRC § 142(a)(12) provides that the term "exempt facility bond" means any bond issued as part of an issue 95 percent or more of the net proceeds of which are used to provide environmental enhancements to hydro-electric generating facilities.

IRC § 142(j) provides that the term "environmental enhancements of hydro-electric generating facilities" means property the use of which is related to a federally licensed hydroelectric generating facility owned and operated by a governmental unit, AND:

- property which protects and promotes fisheries or other wildlife resources, including any fish bypass facility, fish hatchery, or fisheries enhancement facility; OR
- property that is a recreational facility or other improvement required by the terms and conditions of any federal licensing permit for the operation of such generating facility.

Use of Proceeds

At least 80 percent of the net proceeds of the issue must be used to finance property that protects and promotes fisheries or other wildlife resources, including any fish bypass facility, fish hatchery, or fisheries enhancement facility.

Other Requirements

The private activity bond rules stated in IRC §§ 147(a) through (g), and 150(b)(4) are applicable to bonds issued to finance environmental enhancements of hydro-electric generating facilities under IRC § 142(a)(12). The arbitrage and rebate rules of IRC § 148 and the rules of IRC § 149 also apply to these bonds.

These bonds are NOT subject to the Volume Cap under IRC § 146(g)(3).

The rules are discussed in other modules of this text.

Section 13

Qualified Public Educational Facilities

General Rules

Definition

IRC § 142(a)(13) provides that the term "exempt facility bond" means any bond issued as part of an issue 95 percent or more of the net proceeds of which are used to provide qualified public educational facilities.

IRC § 142(k) provides that the term "qualified public educational facility" means any school facility which is:

- part of a public elementary school or a public secondary school; AND
- owned by a private, for-profit corporation pursuant to a public-private partnership agreement with a State or local educational agency.

Schools

IRC § 142(k)(3) provides that the term "school facility" means:

- any school building;
- any functionally related and subordinate facility and land with respect to such building, including any stadium or other facility primarily used for school events; OR
- any property, to which IRC § 168 applies, for use in a facility described above.

IRC § 142(k)(4) provides that the terms "elementary school" and "secondary school" have the meanings given those terms by section 14101 of the Elementary and Secondary Education Act of 1965 (20 U.S.C. 8801), as in effect on December 31, 2001.

Public-Private Partnership Agreement

Under IRC § 142(k)(2), a public-private partnership agreement is an agreement whereby the corporation agrees to:

- either construct, rehabilitate, refurbish, or equip a school facility; AND
- to transfer title of the school facility to the State or local educational agency at the end of the term of the agreement, which may not exceed the term of the bond issue, for no additional consideration.

The agreement operates as a lease-purchase contract whereby the educational agency makes lease payments to the corporation and may take title to the school facility at the end of the agreement without any additional cost.

Qualified Public Educational Facilities

Volume of Issuance Limitations

Under IRC § 142(k)(5), a State is limited in the total aggregate face amount of qualified public educational facility bonds that may be issued during a calendar year to an amount equal to the greater of:

- $10 multiplied by the State population, OR
- $5,000,000.

The State may allocate the permitted amount for any calendar year in any manner it determines appropriate.

A State may elect to carry forward any unused limitation for any calendar year for up to 3 calendar years thereafter under rules similar to those in IRC § 146(f).

Other Requirements

The private activity bond rules stated in IRC §§ 147(a), (b), and (d) through (g) as well as 150(b)(4) are applicable to bonds issued to finance qualified public educational facilities under IRC § 142(a)(13). The arbitrage and rebate rules of IRC § 148 and the rules of IRC § 149 also apply to these bonds.

These bonds are NOT subject to the Volume Cap under IRC § 146(g)(3).

The rules are discussed in other modules of this text.

Section 14

Enterprise Zone Facilities

General Rules

Definition

IRC § 1394(a) provides that the term "exempt facility bond" means any bond issued as part of an issue 95 percent or more of the net proceeds of which are used to provide any enterprise zone facility.

IRC § 1394(b)(1) provides that the term "enterprise zone facility" means any qualified zone property the principal user of which is an enterprise zone business, and any land which is functionally related and subordinate to such property.

Treas. Reg.§ 1.1394-1(i) generally provides that the term "principal user" means the owner of the financed facility.

Qualified Zone Property

Under IRC § 1397D, as modified by section 1394(b)(2), the term "qualified zone property" means any property to which section 168 applies that:

- was acquired by the taxpayer by purchase after the effective date of the zone designation;
- the original use of which in the zone commences with the taxpayer; and
- substantially all of the use of which is in a zone and is in the active conduct of a qualified business by the taxpayer in such zone.

Treas. Reg.§ 1.1394-1(h) provides that the term "original use" means the first use to which the property is put within the zone. For this purpose, if property has been vacant for at least a 1-year period including the date of zone designation, use prior to that period is disregarded. De minimis incidental use is also disregarded.

IRC § 1397D provides special rules for substantial renovations and sale-leasebacks.

Enterprise Zone Facilities

Enterprise Zone Business	The term "enterprise zone business" is defined in IRC § 1397C as modified by section 1394(b)(3). Treas. Reg.§ 1.1394-1(e) provides further guidance on the resident employee requirements of IRC § 1397C(b)(6) and (c)(5).
Substantially All	For purposes enterprise zone facility bonds, Treas. Reg.§ 1.1394-1(l) provides that in applying the rules governing qualified zone property and enterprise zone businesses, the term "substantially all" means 85 percent.
Period of Compliance	The rules governing the periods of compliance with certain requirements applicable to enterprise zone facility bonds, as set forth in IRC §§ 1394, 1397C, and 1397D, are set forth in Treas. Reg.§ 1.1394-1(b) and (c).
Limitation on Amount of Bonds	IRC § 1394(c) prohibits the aggregate amount of outstanding enterprise zone facility bonds allocated to any person from exceeding: • $3,000,000 with respect to any 1 empowerment zone or enterprise community; OR • $20,000,000 with respect to all empowerment zones and enterprise communities.
Acquisition of Land	Under IRC § 1394(d), the restrictions on the acquisition of land and existing property under sections 147(c)(1)(A) and (d) do not apply to enterprise zone facility bonds.
Failure to Meet Requirements	IRC § 1394(e) and Treas. Reg.§ 1.1394-1(n) provide correction procedures and penalty provisions relating to noncompliance with applicable rules.

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Enterprise Zone Facilities, Continued

Current Refundings	Under Treas. Reg.§ 1.1394-1(o)(1), when current refunding bonds are issued after the zone designation period, both the prior issue and the refunding issue, if treated as a single combined issue, must meet all of the requirements for enterprise zone facility bonds, except for the requirements of IRC § 1394(c).
Pooled Financings	Treas. Reg.§§ 1.1394-1(f), (g)(2), and (m)(2)(ii) provide specific rules applicable to certain pooled financing bond programs and loan recycling programs relating to enterprise zone facilities.
Empowerment Zone Facilities	IRC § 1394(f) describes how these rules apply to bond-financed facilities located in empowerment zones designated under IRC § 1391.

Summary of Module E

Review of Module E

IRC §§ 142 and 1394 provide that a bond will be considered to be an exempt facility bond if 95 percent or more of the net proceeds of the bond are used to provide any one of the following facilities:

- airports,
- docks and wharves,
- mass commuting facilities,
- sewage facilities,
- solid waste disposal facilities,
- qualified residential rental projects,
- facilities for the local furnishing of electric energy or gas,
- local district heating or cooling facilities,
- qualified hazardous waste facilities,
- high-speed intercity rail facilities,
- environmental enhancements of hydroelectric generating facilities,
- qualified public educational facilities, or
- enterprise zone facilities.

IRC § 142(b)(1) provides that certain exempt facility bonds must be governmentally owned. These are:

- airports,
- docks and wharves,
- mass commuting facilities, and
- environmental enhancements of hydroelectric generating facilities.

IRC § 142(b)(2) provides general rules regarding offices that apply to ALL bonds described in IRC § 142(a).

Current regulations applicable to most exempt facility bonds are in Treas. Reg.§ 1.103-8, however this section still contains the "substantially all" requirement, which pertains only to bonds issued prior to the TRA 1986.

Current regulations for applying the private business tests to output contracts are in Treas. Reg.§§ 1.141-7 and -8 and generally apply to bonds issued on or after February 23, 1998.

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Summary of Module E, Continued

Review of Module E (continued)

The "public use" and the "functionally related and subordinate" rules contained in Treas. Reg.§ 1.103-8(a)(2) and (3) are still applicable to bonds issued after 1986. Remember that these rules apply to ALL exempt facility bonds.

Treas. Reg.§ 1.142(a)(5)-1 contains rules for sewage facilities, and applies to bonds issued after February 21, 1995.

Treas. Reg.§§ 1.142(f)(4)-1 and 1.150-5 regarding the election to terminate tax-exempt bond financing of electric energy or gas facilities apply to elections made and notices filed on and after February 23, 1998.

Treas. Reg.§ 17.1 contains temporary rules for allocation of costs relating to property used for both a solid waste disposal function and a function other than the disposal of solid waste. See TD 7362, 40 FR 26028, June 20, 1975.

Treas. Reg.§ 1.1394-1 contains rules for enterprise zone facilities.

In addition to meeting the general rules governing exempt facility bonds, there are specific requirements set forth for each particular type of bond that must be satisfied.

Lastly, these bonds must also meet the applicable requirements of Code sections 146 through 150.

Preview of Module F

Module F continues the text's discussion of qualified private activity bonds. It covers bonds described in IRC § 143, which are:

- qualified mortgage bonds, AND
- qualified veterans' mortgage bonds.